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Honorable A.V. "Bill" Hardt, Chairman
Senate Finance Committee
Co-Chairman of the Joint Committee
on Arizona's Tax Structure
Arizona State Senate
Phoenix, Arizona 85007

Dear Senator Hardt:

In your letter of December 23, 1975, you asked the following questions:

> 1. May the State of Arizona adopt a state income tax law which provides that the gross income base of individuals for Arizona tax purposes shall be the federal adjusted gross income?
>
> a. If yes, what are the alternative ways in which this can be accomplished?
>
> b. If yes, what are some of the general difference areas between federal adjusted gross income and Arizona adjusted gross income which should be correlated for purposes of [your] study?

You also asked us to apply the same three questions enumerated above to the question of utilizing federal taxable income as the Arizona taxable income base.

Thirty-eight states use federal income in some manner as the basic starting point for computing state income taxes. The one possible obstacle to such a procedure in Arizona is Article IX, Section 1 of the Arizona Constitution which provides in part:

> The power of taxation shall never be surrendered, suspended, or contracted away...

In Wallace v. Commissioner of Taxation, 289 Minn. 220, 184 N.W.2d 588 (1971), the Supreme Court was asked to determine the legality of a statutory provision that defined "gross income" of individuals, estates and trusts as meaning the adjusted gross income as computed for federal income tax purposes as defined in the laws of the United States for the taxable year, with certain modifications. Article 9, Section 1 of the Minnesota Constitution also contained the same prohibition as Article 9, Section 1 of the Arizona Constitution.

In holding that the effect of the statutory provision was to adopt Federal law as it existed at the time the statute was adopted, the Court stated at 184 N.W.2d 591:

> [I]t may be said that the principle which controls is that a state legislature may not delegate its legislative powers to any outside agency, including the Congress of the United States. The reason for this rule is that changes in the foreign legislation may not fit the policy of the incorporating legislature and the person subjected to the changed law would be denied the benefit of the considered judgment of his legislature on the matter. The basic objection derives from the principle that laws should be made by elected representatives of the people responsible to the electorate for their acts. That principle is expressed in Minn. Const. art 9, §1, which states in part: 'The power of taxation shall never be surrendered, suspended or contracted away.'

The Court therefore refused to give effect to certain amendments to the Internal Revenue Code modifying the method of computing adjusted gross income which became effective after the adoption of the Minnesota Statute.

This interpretation of the law is also supported by the case of Thorpe v. Mahin, 43 Ill.2d 36, 250 N.E.2d 633(1969).

The Illinois income tax act, as originally adopted, only referred to the Internal Revenue Code as in effect on the date of the enactment of the Act. The act was upheld by the Court because it did not attempt to incorporate future federal legislation. In order to be able to incorporate future federal law, Illinois amended its Constitution by providing in Article 9, Section 3(b) that in any income tax law, reference may be made to prospective federal legislation.

Finally, it should be noted that of the eighteen states whose constitution contains a prohibition similar to Arizona's, only four have adopted by reference prospective federal legislation without constitutional change. The remaining states that have adopted prospective federal legislation by reference either have no specific constitutional prohibition, or their constitution was specifically amended so as to authorize such adoption.

From the foregoing, it is apparent that the weight of authority favors the proposition that prospective federal legislation may not be adopted by reference in the absence of Constitutional authorization, if there is a constitutional prohibition against the surrender, suspension, or contracting away of the power of taxation.

Of the four states that do adopt prospective federal legislation in the face of a constitutional prohibition, Alaska and Montana enacted their income tax act prior to the adoption of the constitutional prohibition. Louisiana and Pennsylvania did have the constitutional prohibition at the time their Income Tax Act was enacted. Neither Louisiana or Montana have judicially decided the constitutionality of their income tax act.

The legality of the Alaska Income Tax Act was decided in Alaska Steamship Co. v. Mullaney, 180 F.2d 805 (1950). Since the case was decided prior to the statehood of Alaska, a specific constitutional prohibition was not involved. The Court held that since the Internal Revenue Code had not been amended since the passage of the Act, the question of the adoption of future amendments was not before the Court. The Court went on however, and stated that the purpose of the Act was uniformity and convenience, and the Alaska Legislature, which alone could make this decision,

was itself acting, and was not abdicating its functions, nor making an invalid delegation to Congress. The primary authority relied on by the Court were a reference to the Conformity Act (17 Stat. 196, 197) in the dissenting opinion in Knickerbocker Ice Co. v. Stewart, 253 U.S. 149, 40 S.Ct 478, 64 L.Ed 834 (1920), the fact that reciprocal and retaliatory legislation exist in other areas, and California Rev. and Taxation Code §13442, which stated that if no estate taxes are payable by an estate to California, but there are estate taxes payable to the federal government, then the state will assess taxes up to the amount of tax credit allowed by the federal estate tax law. As can be seen, none of the authoritites relied on by the Court involved the precise issue presented.

Prior to the enactment of its corporate income tax law, Pennsylvania levied an excise tax for the privilege of doing business. The tax was levied at a rate of ten percent of all net income of the company. Net income was defined as net income for the calendar or fiscal year as returned to and ascertained by the federal government. In Commonwealth v. Warner Bros. Theaters, 345 Pa. 270, 27 A.2d 62 (1942), the Court upheld the legality of the excise tax, and held that the tax did not violate the uniformity clause of Article IX, Section 1 of the Pennsylvania Constitution. In reaching its decision, however, the Court made no mention of the comparable constitutional provision, providing that the power to tax corporations and corporate property shall not be surrendered or suspended by any contract or grant to which the commonwealth shall be a party.

The Court, in its decision, stated that net income was the base upon which the tax is measured, and not the tax itself, and that the manner in which net income was fixed by the federal government was of no concern to the taxing officers of the State nor to its statute. While the rate of the income tax or the method of its computation may vary, as a base, net income is unvarying. The Court further stated that this was an excise tax, and not a direct tax on income; and that while an income tax law that provided that it should be the same as fixed by the federal government from time to time would be an unconstitutional delegation, the act in question did not delegate the power to tax to the federal tribunal. It only takes the net income fixed by the federal government as the base for the excise privilege tax levied by the Commonwealth. The cases principally relied upon by the Court in Warner Bros. dealt with the adoption of existing and not future federal legislation.

In Ray Stone Transfer Co. v. Messner, 64 Dauph Co. 240 (Pa. 1953), the constitutionality of the Pennsylvania Corporate Income Tax Act was challenged on similar grounds. The Court, citing Warner Bros., supra, held that the rate of tax and the method of computation were imposed by the State legislature. The Court further held that if it was permissible to measure an excise tax pursuant to federal laws, then it should also be permissible when the income itself is the subject of the tax. Again, Article IX, Section 3 was not mentioned by the Court.

From the foregoing, it would appear that in order for the State of Arizona to adopt an income tax law that would adopt by reference any future federal legislation it would be necessary for the State to adopt a constitutional amendment authorizing such legislation. The foregoing would apply to both the use of federal adjusted gross income and federal taxable income as a base.

If a constitutional amendment is not feasible, it would be possible to adopt certain portions of the Internal Revenue Code in existence at the time of the adoption of the Income Tax Act. Numerous states have accomplished this result by specifically defining the Internal Revenue Code as the Internal Revenue Code of 1954, as it existed on a specified date, or at the time of adoption. The state legislature then periodically changes the specified date. As long as the date is updated annually, the result is substantially the same as if the statute only specified the current Internal Revenue Code.

Whether a proposed Arizona Income tax law incorporates federal adjusted gross income, or taxable net income, basically the same sections of the Internal Revenue Code and of the Arizona Revised Statutes would have to be correlated. The reason for this is that in arriving at adjusted gross income, both I.R.C. §62(1) and A.R.S. §43-112(f)(1) allow as deductions from gross income items generally deductible only from adjusted gross income, if such deductions are attributable to a trade or business carried on by the taxpayer and such trade or business does not consist of the performance of services by the taxpayer as an employee. The following are some of the general difference areas that will have to be correlated for purposes of your study:

1. A.R.S. §43-112(f) will have to be correlated with I.R.C. §62.

2. The other provisions of A.R.S. §43-112 will have to be correlated with I.R.C. §§ 61, 62, 71-83, 101-123, 471, 472, 893, and 1321.

3. §43-113 will have to be correlated with I.R.C. §§ 108 and 1017.

4. §43-115 will have to be correlated with I.R.C. §692.

5. §§ 43-123.01 through 43-123.39 will have to be correlated with I.R.C. §§ 141 through 144, 161 through 188, 212 through 218 (it should be noted that the deductions allowed by I.R.C. §§ 211 through 218 may only be deducted from adjusted gross income, and may not be used to arrive at adjusted gross income pursuant to I.R.C. §§ 62(1)), 262 through 278, 381 through 383, 401 through 407, 521, 591 through 596, 611 through 617, 691, 856 through 859, 1091, 1245 and 1250.

6. A.R.S. §43-124 will have to be correlated with I.R.C. §1481.

7. A.R.S. §43-126 will have to be correlated with I.R.C. §§ 162, 262 through 279.

8. If federal net taxable income is used as the base, then A.R.S. §43-127 will have to be correlated with I.R.C. §§ 151 through 153 and 642.

9. A.R.S. §43-133 will have to be correlated with I.R.C. §§ 441, 443, 446, 451 and 454.

10. A.R.S. §43-133 will have to be correlated with I.R.C. §461.

11. A.R.S. §43-134 will have to be correlated with I.R.C. §§ 453 and 483.

12. A.R.S. §43-135 will have to be correlated with I.R.C. §§ 267, 269 and 482.

13. A.R.S. §43-136 will have to be correlated with I.R.C. §1301 through 1304.

14. A.R.S. §43-137 will have to be correlated with I.R.C. §443.

15. A.R.S. §43-151 will have to be correlated with I.R.C. §1001.

16. A.R.S. §43-152 will have to be correlated with I.R.C. §351 through 358, 1002, 1031, 1033, 1034, 1036, 1071, and 1081 through 1083.

17. A.R.S. §43-153 will have to be correlated with I.R.C. §§ 307, 334, 731 through 736, 1011 through 1023, 1031 through 1039 and 1091.

18. A.R.S. §43-154 will have to be correlated with I.R.C. §§ 167 and 612.

19. A.R.S. §43-155 will have to be correlated with I.R.C. §§ 301 through 307, 316 through 318, 331, 333 and 346.

20. A.R.S. §43-157 will have to be correlated with I.R.C. §§ 341, 1202, 1211, 1212, 1221, 1231 through 1253.

21. A.R.S. §43-158 will have to be correlated with I.R.C. §691.

22. A.R.S. §43-159 will have to be correlated with I.R.C. §§ 1331 through 1337.

23. A.R.S. §43-160 will have to be correlated with I.R.C. §§ 421 and 1014.

If the estates and trusts are to be taxed as individuals, then the following sections will have to be correlated:

24. A.R.S. §43-161 will have to be correlated with I.R.C. §§ 641 through 643.

25. A.R.S. §43-162 will have to be correlated with I.R.C. §§ 641 through 643, 651, 652, 661 through 664, 665 through 669, 681.

26. A.R.S. §43-163 will have to be correlated with I.R.C. §642.

27. A.R.S. §43-164 will have to be correlated with I.R.C. §682.

28. A.R.S. §43-165 will have to be correlated with I.R.C. §§ 401 through 407.

29. A.R.S. §43-166 will have to be correlated with I.R.C. §673.

30. A.R.S. §43-167 will have to be correlated with I.R.C. §677.

31. A.R.S. §43-169 will have to be correlated with I.R.C. §584.

32. Since partners are individually taxable upon their share of the partnership income, A.R.S. §43-171 will have to be correlated with I.R.C. §701 through 708.

The foregoing is not intended to be a comprehensive list of areas that will require correlation. Because of the comprehensive nature of the Internal Revenue Code, there may be other sections that relate directly or indirectly to the computation of gross income, adjusted gross income or not taxable income of individuals.

As a final note, A.R.S. §43-129 allows an individual taxpayer the option to pay the income tax at the rate prescribed by §43-102 upon the amount of net income for the same taxable year as now defined in Section 21 of the United States Internal Revenue Code in excess of the credits against net income now provided in Section 25 of the United States Internal Revenue Code, with a further deduction allowed for federal income taxes paid.

The Internal Revenue Code referred to in §43-129 is the Internal Revenue Code of 1939. Without passing on the constitutionality or the effect of that section, it is recommended that A.R.S. §43-129 be repealed if the legislature does pass an act utilizing federal adjusted gross income or

federal net taxable income as a base for Arizona Income Tax purposes.

Sincerely,

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